STATE OF IOWA

DEPARTMENT OF COMMERCE

UTILITIES BOARD

IN RE: MIDAMERICAN ENERGY COMPANY	DOCKET NO. RPU-01-9

ORDER

(Issued May 29, 2002)

INTRODUCTION AND PROCEDURAL HISTORY

On November 13, 2001, MidAmerican Energy Company (MidAmerican) filed with the Utilities Board (Board) an application for determination of ratemaking principles for the Greater Des Moines Energy Center (GDMEC), a 540 MW combined-cycle generating unit MidAmerican plans to build in Pleasant Hill, Iowa. This is the first such proceeding, which is pursuant to Iowa Code § 476.53 (Supp. 2001). Section 476.53 was enacted during the 2001 legislative session as part of House File 577. This section provides that when defined new electric generation is constructed by a rate-regulated public utility, the Board, upon request, shall specify in advance, by order issued after a contested case proceeding, the ratemaking principles that will apply when the costs of the new facility are included in electric rates. Section 476.53(1) states that the general assembly's intent in enacting the legislation is to "attract the development of electric power generating and transmission facilities within the state . . ."

The ratemaking principles proceeding is only available to rate-regulated public utilities that build or lease certain defined generation. The statute does not apply to purchase power contracts, meaning that a rate-regulated public utility that purchases electricity from another provider, such as an independent power producer, cannot receive advance ratemaking treatment for that purchase. Other electric utilities, such as municipals and cooperatives, do not need a statute such as section 476.53 to encourage them to build new generation. Those utilities can recover costs of a new plant in any manner approved by their boards or councils, because the Board does not regulate their rates. The proceeding may be used for the following facilities constructed or leased in Iowa:

1. a base load unit with a nameplate capacity of 300 MW or greater; or
2. a combined-cycle facility; or
3. an alternate energy production facility as defined in section 476.42.

The proposed MidAmerican facility qualifies for ratemaking principles as a combined-cycle facility and no party disputed that section 476.53 applies to GDMEC.

In addition to the Consumer Advocate Division of the Department of Justice (Consumer Advocate), Ag Processing Inc (Ag Processing), IES Utilities Inc. and Interstate Power Company n/k/a Interstate Power and Light Company (IPL), and Hawkeye Generating, L.L.C. (Hawkeye), intervened in the ratemaking principles proceeding. All parties except IPL filed prefiled testimony. Consumer Advocate, Hawkeye, and IPL participated at the hearing held beginning April 1, 2002, but IPL did not offer any witness testimony or cross-examine any witnesses. Although Ag Processing did not attend the hearing, its prefiled testimony was admitted into the evidentiary record pursuant to a motion granted by the Board. MidAmerican, Consumer Advocate, and Hawkeye submitted initial and reply post-hearing briefs.

Although Iowa Code § 476.53(3)"d" allows the ratemaking principles proceeding to be combined with a proceeding for issuance of a generation certificate under Iowa Code chapter 476A, the two proceedings were not combined here. MidAmerican's application for a generating certificate was the subject of a separate docket, Docket No. GCU-01-1. The Board granted the certificate, subject to MidAmerican obtaining final pre-construction permits, by order issued March 8, 2002. MidAmerican filed the appropriate pre-construction permits on April 25, 2002, and a "Certificate of Public Convenience, Use, and Necessity" was issued on April 30, 2002.

IMPACT OF RATEMAKING PRINCIPLES DECISION

The decision of the Board in a regulatory principles proceeding has more long-term impact than perhaps any other type of decision the Board makes. This is because a key aspect of section 476.53 is that the ratemaking principles established in this proceeding <u>shall</u> be binding with regard to the specific electric power generating facility in <u>any</u> subsequent rate proceeding. (Emphasis added). In other words, if the decision is not a reasonable one, it cannot be undone in a subsequent rate case. It is important both for the utility and its customers that the Board make a decision that will stand the test of time, because the life of most generating facilities is at least 20 years. In making its ratemaking principles determination, the General Assembly decided that the Board is not limited to traditional ratemaking principles or traditional cost recovery mechanisms. Iowa Code § 476.53(3)"b."

It is interesting to note that while the Board's decision is binding in any subsequent rate proceeding, the utility, after receiving the ratemaking principles decision, retains the option of going forward with the proposed Iowa facility. In other words, if the public utility disagrees with the principles enunciated by the Board, the public utility may decide not to proceed with the facility's construction. However, a decision not to proceed does not relieve the utility of its obligation to serve customers. Iowa Code chapter 476.

RATEMAKING PRINCIPLES AND CHAPTER 476A

While the intent of section 476.53 is to encourage Iowa-built generation by rate-regulated utilities, the legislative intent is not that this generation be built at any cost. Requested principles must be balanced with the impact on the utility's ratepayers. Before determining the applicable ratemaking principles, the Board must make two findings pursuant to Iowa Code § 476.53(3)"c." These are conditions precedent to a determination of ratemaking principles, because if the Board cannot make these findings, the utility cannot receive ratemaking principles. First, the Board must determine that the public utility has in effect a Board-approved energy efficiency plan. Second, the utility must demonstrate that it has considered other sources for long-term supply and that the facility is reasonable when compared to other feasible alternative sources of supply. The utility may satisfy this second criterion through a competitive bidding process pursuant to the Board's rules. MidAmerican is not using the Board's proposed competitive bidding rules (Docket No. RMU-01-8) in this proceeding, and in fact the rules were not adopted until March 15, 2002, and were not effective until May 8, 2002. 199 IAC chapter 40.

The two findings that the Board must make prior to determining applicable ratemaking principles are similar, but not identical, to two of the decision criteria that were stricken from the generation certification or siting chapter, Iowa Code chapter 476A. Significant changes to chapter 476A were also part of House File 577. Prior to the passage of House File 577, Iowa Code § 476A.6(4) provided that if an applicant for a generation or siting certificate was a public utility, it had to have in effect a "comprehensive energy management program," which was to include load management and interruptible service programs and cost-effective energy efficiency and renewable energy services and programs. This decision criteria was deleted from Chapter 476A, but the ratemaking principles statute requires the utility to have "in effect a board-approved energy efficiency plan as required under section 476.6, subsection 19."

Two other decision criteria stricken from Chapter 476A by House File 577 were Iowa Code §§ 476A.6(5) and (6). Subsection 5 criteria required that the siting applicant, if a public utility, demonstrate that it had considered long-term supply from either purchase or investment in facilities owned by others. Subsection 6 required that the public utility consider all feasible alternatives to the proposed facility including nongeneration alternatives. The subsection further required that these alternatives be ranked by cost, that the least-cost alternatives be implemented first, and that the Board find the proposed facility is necessary notwithstanding the implementation of these alternatives.

The ratemaking principles statute does not refer to "least-cost" alternatives. Instead, Iowa Code § 476.53(3)"c"(2) only requires that the "rate-regulated public utility has demonstrated to the board that it has considered other sources for long-term electric supply and that the facility or lease is reasonable when compared to other feasible alternative sources of supply." (Emphasis added). In a ratemaking principles proceeding, the Board does not have to conduct the least-cost analysis formerly required in a siting proceeding involving a public utility. The proposed facility need only be reasonable when compared to other alternative sources of supply.

While cost remains a factor, elimination of the least-cost requirement is consistent with the intent of the ratemaking principles statute, which is to attract electric power generating facilities to this state. Elimination of the least-cost requirement now allows non-cost factors to play a role in the Board's decision that a public utility has satisfied this requirement as a condition precedent to receiving ratemaking principles. These non-cost factors, such as security and reliability, could in some cases be determinative.

CONDITIONS PRECEDENT

Of the two findings that the Board must make prior to granting ratemaking principles, the first is uncontested by any party. There is no disagreement that MidAmerican has in effect a Board-approved energy efficiency plan as required under Iowa Code § 476.6(19). MidAmerican received Board approval of its current energy efficiency plan filed in Docket No. EEP-95-3, on June 28, 1996. A Board order issued on July 27, 2001, in the same docket, extended the plan.

The second finding that the Board must make was disputed by at least one party, Hawkeye. MidAmerican presented an analysis comparing GDMEC with five alternative sources of supply using seven assessment criteria. (Tr. 161-63; 348-69; 372-85; 425-28; 450-98; 546-58). MidAmerican claimed the analysis clearly showed GDMEC is reasonable compared to other feasible alternatives.

Hawkeye claimed that MidAmerican discouraged the consideration of alternatives by withdrawing an earlier request for proposals it had issued for new supply. In particular, Hawkeye contended it had presented MidAmerican with a purchase power alternative that is at least $40 million cheaper than GDMEC.

The Hawkeye "proposal" contained many unanswered questions, including assurances that its parent company would support the project, assurances of financial viability, and a full explanation of the costs and risk allocations. (Tr. 788-27; 834-37). In addition, contrary to Hawkeye's assertion, MidAmerican did evaluate purchase power agreements. (Tr. 245-48). In its analysis, MidAmerican believed it was reasonable to use spot market purchases as a proxy for long-term purchase power agreements, based on the assumption that purchase power agreements will always be priced higher than spot market because of the purchase power agreement's lack of short-term pricing flexibility. (Tr. 474).

GDMEC ranks favorably when compared to the other alternatives provided or explored. In particular, GDMEC is uniquely qualified, because of its location, to provide security and reliability for the Des Moines area. Hawkeye's project, located outside the Des Moines area, could not provide these benefits. (Tr. 363-66; 468-70). When both cost and non-cost factors are considered, GDMEC is reasonable compared to other feasible alternatives. There are simply too many unanswered questions regarding Hawkeye's proposal for it to be considered as a feasible alternative for analysis.

While the Board believes that in this case MidAmerican has met its burden of establishing that GDMEC is reasonable when compared to other feasible alternatives, the Board notes that non-cost factors play a particularly important role in the analysis because of the need for additional security and reliability for the Des Moines area, which only GDMEC can provide. In circumstances where non-cost factors are less important, the Board questions whether spot market purchases would provide an adequate proxy for long-term purchase power agreements. In the future, the Board will expect utilities seeking ratemaking principles to provide more than a proxy assessment of long-term power markets, whether this is by competitive bidding pursuant to the Board's rules or some other method.

GENERAL OBSERVATIONS

Once the conditions precedent are satisfied, the Board can consider the ratemaking principles requested by the utility. The ratemaking principles statute encourages utility-built generation in Iowa, because it provides for the establishment of ratemaking principles prior to construction of a proposed facility. While ratemaking treatment of generation facilities is generally well established by prior regulatory precedent, there are risks associated with not having ratemaking treatment established until a rate case that occurs subsequent to construction of the facility. The large capital expenditure required plus the lead-time in bringing a facility on line creates risk. Changes in Board policy or circumstances, such as an unforeseen decrease in demand, could impact the ratemaking treatment in a future rate proceeding. The possibility of such changes imposes risks to the utility that the statute eliminates by making the principles approved by the Board "binding with regard to the specific electric power generating facility in any subsequent rate proceeding." Iowa Code § 476.53(3)"g."

Although some of the ratemaking principles requested by MidAmerican are in dispute, most of the principles requested are generally consistent with what one would expect a regulated utility to request. This is consistent with the traditional regulatory compact, which provides the utility with regulatory assurances in exchange for its obligation to serve within its exclusive service territory. The Board traditionally addresses issues of depreciable life, recoverable capital costs, and excess capacity treatment in a rate case where a utility seeks to recover the costs of a new plant addition. An advance determination of the exact principles to be applied to these items significantly reduces the risks of being second-guessed by regulators after capital for the new plant has been committed. Before undertaking such a significant capital commitment, it is reasonable to expect an advance determination of the ratemaking principles regulators will apply.

Advanced determination of a plant specific return on equity, however, is a different matter. Here, MidAmerican requests a return on equity that is based on similar returns for projects in the competitive market, not the regulated market. This does not necessarily represent a balanced approach because competitive generators do not have available to them exclusive service territories with a guaranteed customer base or regulatory assurances for such things as the recovery of capital costs, fuel costs, and operation and maintenance expenses. Competitive generators bear the risk of being second-guessed by the market. In addition, a competitive generator generally sells output only to a few significant customers. If a customer goes out of business or bankrupt, the competitive generator may not have another customer to purchase that output. If a public utility customer goes out of business or bankrupt or leaves the service territory, all other ratepayers pick up that customer's share of the costs and utility cost recovery remains assured.

In determining return on equity, the Board believes the return should be based, at least in part, on the risks the utility has undertaken. The more risks the utility takes, the higher the return; the more risks transferred to ratepayers by regulatory assurances, the lower the return. If the ratemaking principles granted significantly lower the project's risk to the utility, the return on equity should be closer to a traditional regulated return. If the utility has decided to forego traditional regulatory assurances, the return on equity should be closer to that which would be expected in the competitive market.

The Board believes that ratepayers will accept the concept of higher returns for the utility if the utility accepts corresponding risk. However, customers should not accept a granting of traditional regulatory assurances, including assured recovery of capital, fuel, and maintenance costs, plus a rate of return based on the competitive market. This approach would give the utility all of the benefits of a regulated entity with the returns of a competitive provider, but because of the exclusive service territory concept customers would be unable to take advantage of the competitive environment. The approach adopted by the Board must be balanced because the Board's determinations will impact ratepayers in all subsequent rate proceedings for the life of the proposed facility. Recent developments in telecommunications and wholesale generator industries underscore that the returns realized are subject to significant risks inherent in a competitive market that are not present in a public utility's regulated operations. Because of this interplay between risk and reward, the Board will address return on equity last in its analysis.

DISCUSSION OF RATEMAKING PRINCIPLES
SUMMARY OF UNCONTESTED RATEMAKING PRINCIPLES

MidAmerican has requested that the Board establish eight regulatory principles. Four are uncontested by other parties. The uncontested principles requested are:

1. Capital Structure and Cost of Debt and Preferred Securities.

The capital structure ratios and costs (except for the cost of common equity) shall be determined in each rate proceeding by the Board in a fashion identical to the capital structure used for the remainder of MidAmerican's electric operations.

2. Jurisdictional Allocation.

The GDMEC capital and operating costs will be included in Iowa regulated retail electric rates consistent with the methodology used to allocate capital and operating costs of other MidAmerican generating facilities. This represents a change from the initial filing, where MidAmerican proposed to allocate all costs of the new plant to Iowa. Consumer Advocate contested the initial proposal.

3. Other Plant Components.

Except as specifically addressed in other ratemaking principles, MidAmerican will not seek any departures from traditional ratemaking with respect to allowance for funds used in construction[1] (AFUDC), construction work in progress[2] (CWIP), investment, and plant expenses.

4. Settlement Impact.

Electric rates will not be adjusted to reflect increases in investment, costs and revenues from GDMEC until addressed in a future rate case after the expiration of the settlement approved by the Board in Docket Nos. RPU-01-3 and RPU-01-5.

The uncontested ratemaking principles are consistent with past regulatory treatment for these types of items and will be adopted by the Board. The settlement referred to in item 4 includes, among other things, a rate freeze that expires in 2005.

DISCUSSION OF CONTESTED RATEMAKING PRINCIPLES

1. Depreciable Life

MidAmerican states its 25-year depreciable life proposal is based upon its review of the depreciable lives of other utilities that have combined-cycle combustion turbine units in their generation mix. (Tr. 265). MidAmerican notes it is not proposing

[1] Allowance for funds used in construction (AFUDC) is the estimated cost of funds used to finance construction of utility projects.

[2] Construction work in progress (CWIP) is the actual money spent on a utility construction project prior to the project going in service. Once the project goes in service, the amount in the CWIP account for that project rolls over to the plant in service account, which is part of rate base. This amount would be recovered in rates in a 476.6 rate proceeding. AFUDC, or the cost of financing, is part of the CWIP account and is also rolled over to the plant in service account when the project is placed in service. Once CWIP for a particular project is rolled over to plant in service, AFUDC no longer accrues on that amount.

the 20-year accelerated depreciation that the federal government allows for income tax purposes. (Tr. 301).

Consumer Advocate and Ag Processing both object to a 25-year depreciable life for ratemaking purposes. Consumer Advocate argued that 30 years would be more appropriate and pointed out that Cordova Energy Center, which is similar in design to GDMEC and owned by a MidAmerican affiliate, uses a 30-year depreciable life. Consumer Advocate also pointed out that the EPRI Technical Assessment Guide supports a 30-year depreciable life for GDMEC. (Tr. 640-41).

Both MidAmerican and Consumer Advocate use essentially the same survey data to support their arguments. This data consists of the depreciable life for combined cycle facilities used by other utilities. Combined-cycle technology is too new for precise figures on known useful or depreciable life to be available. Because precise information is not available, the Board will use an average of the combined-cycle depreciable lives included in MidAmerican's survey. Using this average, the depreciable life of GDMEC for ratemaking purposes will be 27.6 years.

2. Excess Capacity

MidAmerican argues that the addition of GDMEC to its generation mix is a prudent decision that should never result, directly or indirectly, in an excess capacity penalty. To ensure this result, MidAmerican proposed a ratemaking principle that has two essential components. First, the GDMEC capacity shall not be included in any determination of excess capacity during the life of GDMEC. Second, the GDMEC investment shall not be included in the calculation of any excess capacity penalty. MidAmerican will, however, consider GDMEC when it is determining whether future capacity additions are necessary. MidAmerican noted that none of the other parties disputed MidAmerican's current need to build capacity.

Consumer Advocate argued that MidAmerican's proposal guaranteed that MidAmerican would not be subject to any excess capacity penalties or adjustments in the future, even if MidAmerican built or purchased significant amounts of additional capacity, and that the impact of MidAmerican's proposal is to artificially understate its reserve margin. Consumer Advocate agreed there should be no excess capacity from GDMEC if MidAmerican does not build, purchase, or otherwise acquire capacity additions subsequent to GDMEC, except for capacity replacing a retiring plant or expiring contract. In other words, Consumer Advocate agreed that MidAmerican should be protected as long as MidAmerican does not add more capacity than is needed to replace existing resources.

MidAmerican reminded the Board that MidAmerican's predecessor companies had received regulatory approval to build new generating facilities but that, when growth in demand did not meet expectations, those companies were denied the opportunity to recover the cost of common equity on a portion of the generating assets that were deemed to be excess. This type of "penalty" was later codified in former Iowa Code § 476.53, which provided that the Board not allow a return on common equity on that portion of a public utility's generating capacity which was deemed to be excess capacity. This statute was repealed as part of House File 577. However, the Board retains authority under Chapter 476 to make adjustments if it determines there is excess capacity. The adjustments or "penalties" MidAmerican refers to were imposed prior to passage of the excess capacity statute.

Any ratemaking principle that eliminates the risk of a future excess capacity adjustment significantly lowers risk to the utility. However, MidAmerican's proposed ratemaking principle is too broad and does not present a balanced approach because it only deals with GDMEC capacity, with no adjustment for corresponding load. At hearing, MidAmerican witness Stevens presented a more balanced approach by proposing that for 100 percent of GDMEC capacity to be exempted from excess capacity, a corresponding load adjustment should be made. (Tr. 389-90). The load adjustment is computed by dividing the plant capacity by the normal weather planning reserve margin. For example, for a 540 MW plant, a 450 MW (540/1.20) load would also be removed. (Tr. 390). This is similar to MidAmerican's initial proposal in that it removes GDMEC capacity from a future excess capacity calculation, but it differs in that it also excludes corresponding load. Recovery of GDMEC costs, which will be discussed next, would also be excluded from any excess capacity calculation.

The Board believes these assurances on excess capacity provide certainty to shareholders while at the same time offering ratepayers protection, because corresponding load adjustments will be made with the capacity adjustments. The reduction of risk to MidAmerican from these assurances cannot be understated. MidAmerican will not be subject to any future excess capacity penalties for GDMEC. This kind of guarantee, regardless of subsequent events, is not available in the competitive market or under traditional ratemaking.

3. Capital Cost Recovery

MidAmerican proposed that the Iowa portion of the actual costs of GDMEC be included in the rates of customers without further review for prudence or reasonableness, subject to a "soft cap" of $368.829 million without AFUDC or $414.788 million with AFUDC. If actual costs exceed the cap, MidAmerican said these could be recovered if shown to be reasonable and prudent. If actual costs are lower than the cap, MidAmerican will include only actual costs in the cost of service calculation.

Pursuant to MidAmerican's proposal, AFUDC will be computed in accordance with FERC requirements and will be subject to earnings offsets in accordance with the revenue sharing provision in the Settlement Agreement in Docket Nos. RPU-01-3 and RPU-01-5. To the extent AFUDC is recovered through the revenue sharing requirements, there will be a dollar-for-dollar reduction in the cap. MidAmerican said that AFUDC will not serve to be an added contingency amount should the actual AFUDC be less than the forecasted amount.

Consumer Advocate agreed to the concept of a cap, but said it should include only those capitalized GDMEC components that were subject to competitive bidding, with the cap for each component set at the lowest bid level. For items not included in the cap, Consumer Advocate would require MidAmerican to prove that the costs were reasonable and prudent, at the time the completed plant is to be put in rates.

Because the revenue sharing mechanism in Docket Nos. RPU-01-3 and RPU-01-5 is projected to be sufficient to pay the AFUDC associated with GDMEC, the Board will address this issue in terms of capital costs without AFUDC. The number to start with is the "soft" $368.829 million cap proposed by MidAmerican.

When MidAmerican filed its case, MidAmerican and Consumer Advocate were approximately $120 million apart in amounts that would be included in the cap. However, as the case progressed and competitive bidding on more plant components was completed, approximately 90 percent of GDMEC's costs, exclusive of AFUDC, meet Consumer Advocate's test for inclusion in rate base without further proceedings. Translated into dollars, there is agreement on approximately $332 million of the total costs.

The areas that remain in dispute are the $18.2 million contingency fund, and the $19.3 million in internal MidAmerican costs and other costs not subject to competitive bidding. Most of the internal costs are for internal labor. Other costs include sales taxes, water pipeline and sewer connection charges, procurement of fuel for start-up, and negotiation of pipeline right-of-way. Consumer Advocate argued the Board should retain the right to review the reasonableness of "change orders" and other expenses not subject to competitive bidding.

The internal MidAmerican costs and other costs not subject to competitive bidding appear to be costs one would expect for this type of project. While the evidence does not generally suggest the types of costs or total amounts are unreasonable, a ratemaking principles proceeding is not designed to examine costs in the detail or depth of a prudence review conducted in a rate case after completion of a project. However, there is sufficient evidence to exclude from any cap the sum of $488,004, which represents interest charges on the combustion turbine units that were transferred to MidAmerican by its parent, MidAmerican Holdings. (Tr. 324-26).

Hawkeye stated that the value of these units today is substantially less than when MidAmerican purchased them. (Tr. 836). However, there is no evidence to suggest the price paid for the units at the time they were transferred was unreasonable. Nevertheless, the Board believes it is appropriate to exclude the interest charges because MidAmerican Holdings, after canceling a Wisconsin project, did not have a need for the units until MidAmerican announced the GDMEC project. There is no evidence presented to show that MidAmerican Holdings would have recovered its cost, plus interest, if the units had to be sold on the open market rather than to its affiliate, MidAmerican.

The other amount in dispute is the contingency fund. The total amount of the fund, $18.25 million, does not appear unreasonable for a project this size. This amount represents 5 percent of GDMEC's costs. The fund is excessive, though, because by the time of the hearing 90 percent of the project's costs had been competitively bid and locked in. However, it is likely there will be some change orders and unforeseen items that will use at least part of the contingency fund.

The primary issue the Board has with MidAmerican's proposed ratemaking principles regarding capital costs is that they do not present a balanced approach. MidAmerican does not want the Board to review the prudency or reasonableness of any costs, including change orders and internal costs, unless these costs cause the "soft" cap to be exceeded. MidAmerican seeks the flexibility to manage project costs without Board oversight, with the added safety net of Board review for any costs that exceed the "soft" cap. The amount of the "soft" cap proposed by MidAmerican, though, includes a contingency fund that is too large given that 90 percent of GDMEC's capital costs have been locked in by competitive bid. This does not provide adequate ratepayer protection from excessive costs or misallocation of internal costs.

Therefore, while the Board will adopt the "soft" cap amount proposed by MidAmerican, the cap will be set at a lower amount.

Because the amounts that remain unknown are MidAmerican's internal costs and other costs not subject to competitive bid, including change orders, within the limits of the contingency fund, this should present minimal risk to MidAmerican. Ninety percent of the project's costs have been locked in by competitive bids. Most of the internal costs are labor costs of MidAmerican personnel, an amount within the control of MidAmerican. The size and scope of any change orders is also within the control of MidAmerican. Reducing the amount of the contingency fund provides MidAmerican with the appropriate incentives to bring this project in at or under budget. A large contingency fund does not provide these incentives because there is no Board review until the "soft" cap is exceeded.

The Board will reduce the amount of the contingency fund to $7.4 million, which represents about 20 percent of the project's costs not subject to competitive bidding. Using this amount for the contingency fund and subtracting the interest charges paid by MidAmerican to its parent, the Board will set the "soft" cap, exclusive of AFUDC, at $357,487,996.

Hawkeye and Ag Processing both argued MidAmerican's projected costs were too high, but offered no credible evidence to support their claims. The cost figures contained in the Minnesota report submitted by Ag Processing reflected only construction costs and do not include future operation and maintenance costs. The other study cited by Ag Processing was not clear about what costs were included in the estimate.

Hawkeye claimed that the plant could be built for $40 million less than MidAmerican's figures. However, while it may be true that combustion turbines are less expensive today, Hawkeye presented no evidence that the price paid by MidAmerican when it purchased them was unreasonable. Hawkeye's assertion and submission is not backed by credible evidence with which the Board can evaluate its claim. From the evidence presented, the project's costs are within the zone of reasonableness.

4. Cost of Capital

Before directly addressing cost of capital, it is important to recap the regulatory principles MidAmerican will receive in this proceeding. These principles, which are binding with regard to GDMEC in any subsequent rate proceeding, have substantially reduced the risk to MidAmerican associated with GDMEC. (Tr. 220-35).

Of the uncontested ratemaking principles, perhaps the most significant is that MidAmerican will not seek any departures from traditional ratemaking with respect to plant expenses. In other words, under traditional ratemaking principles, MidAmerican may seek to recover in its next rate case, among other things, fuel costs and operation and maintenance expenses associated with GDMEC. This provides significant protections for MidAmerican with respect to recovery of those items, which represent the ongoing expenses of operating and maintaining the plant.

Of the contested ratemaking principles, the Board's decisions on excess capacity and capital cost recovery provide upfront protection on two of the most significant risk items. This upfront protection was not available under traditional ratemaking and the availability of these protections through the ratemaking principles proceeding substantially reduces the risk associated with a rate-regulated utility's construction of new generation.

With respect to the final contested ratemaking principle, cost of capital, MidAmerican proposed a fixed return on common equity associated with its investment in GDMEC of 13.25 percent as "long as GDMEC continues to be a Board rate-regulated utility asset." (Tr. 19, 425). MidAmerican said its request was premised on the Board's grant of all the other requested ratemaking principles; otherwise, MidAmerican said its required return would be in the range of 14 to 15 percent. (Tr. 54). MidAmerican argued the rate of return should reflect the risk, not of MidAmerican as a whole, but of its investment in GDMEC.

Consumer Advocate witness Vitale proposed 9.2 percent as the current cost of equity that MidAmerican will invest in GDMEC. Consumer Advocate witness Habr suggested that in lieu of a fixed cost of equity over the life of GDMEC, the Board could instead fix the amount of a premium or add-on to apply in later rate cases to a representative yield on A-rated utility bonds, at the time of those subsequent proceedings. Dr. Habr recommended this add-on be determined by taking the difference between the common equity return allowed by the Board in this proceeding and Moody's average yield for A-rated utility bonds for the 12 months ending February 28, 2002. Ag Processing and Hawkeye both expressed concerns that the 13.25 rate requested by MidAmerican was higher than needed to attract capital to GDMEC because it represented the return equivalent to unregulated investments without the risks of those investments.

There was some confusion at hearing over what risks MidAmerican was accepting with its requested 13.25 percent return. MidAmerican witness Dr. Morin indicated that he assumed there would be no automatic fuel adjustment clause, because this was the current status. (Tr. 139). This testimony was later disavowed by MidAmerican witness Alexander. (Tr. 245). Also, at one point Dr. Morin indicated the requested return compensated MidAmerican for stranded costs related to GDMEC in the event of future deregulation. (Tr. 133). Later, however, another MidAmerican witness said any stranded costs would be dealt with in a separate proceeding. MidAmerican did not commit to forgo stranded cost recovery for GDMEC. (Tr. 236-37).

The Board concludes that MidAmerican is not accepting any additional fuel cost or stranded cost risk with respect to GDMEC, although these items appear to have been factors in their expert's analysis justifying a 13.25 percent return. It is not known what Dr. Morin's cost of equity recommendation would be if those risks were removed from his analysis.

Because MidAmerican stock is not traded in the open market, there is no MidAmerican stock price that can be used to gauge investors' expectations. In using market-based cost of equity models like the discounted cash flow (DCF) method and capital asset pricing model (CAPM) to determine the cost of equity for MidAmerican, proxies for companies comparable to MidAmerican must be used. The dispute is over what are comparable companies.

MidAmerican's analysis uses competitive unregulated companies such as independent power producers and telecommunications companies. By solely using unregulated companies, the analysis ignores the more assured cash flows that can be expected because of GDMEC's regulatory protections and MidAmerican's captive customer base. In addition, the Board has other serious concerns about the proxy companies selected. Because of the recent problems that have plagued both the telecommunications and wholesale generator/independent power producer industries, the Board believes an analysis using the same companies might produce significantly different results if performed today. The returns in Dr. Morin's analysis do not appear sustainable, on a long-term basis, in today's market. While competitive entities might achieve high growth over short periods, the cost of equity determined in this proceeding will apply over a much longer period.

While more persuasive than MidAmerican's analysis, Consumer Advocate's use of regulated gas and electric companies also raises concerns because it does not capture the inherent risks in building new generation. The returns used are for combination gas and electric utilities as a whole. These returns represent returns on the utilities as a whole and are not persuasive for use in setting an independent return on a generation investment because the returns cited blend high risk and low risk capital investments made by the utilities. The analyses of both MidAmerican and Consumer Advocate using proxy companies provide a useful check on other methods to determine return on equity, such as the risk premium analysis. However, neither analysis on its own is persuasive in determining return on equity.

MidAmerican and Consumer Advocate also disagreed on whether a fixed or floating return should be used. A fixed return provides certainty for evaluation of GDMEC's risks and returns. A floating rate provides less certainty but provides latitude such that future changes in the capital market will be taken into account. Both methods have their own risks and rewards depending on how the capital markets perform in the future.

While the floating rate has considerable appeal, the Board believes in this case, at this time a fixed rate can be set. A floating return, at least from the historical perspective, is more likely to increase rather than decrease costs to ratepayers.

The difficult question is determining the rate. An argument could be made that because of the other principles granted in this proceeding, MidAmerican's investment in GDMEC is actually less risky than an investment in other traditional utility assets where an advance determination of ratemaking treatment is not available. However, this argument ignores the fact that most ratemaking principles are generally known and can be accurately predicted in most instances. The Board also continues to believe that, because of the large capital cost, deregulation in the wholesale markets, and the ever-present possibility of retail restructuring or deregulation, generation investments are more risky than other regulated-utility investments.

The Board's risk premium approach, which adds 250 to 450 basis points to the most current A-rated utility bond published yield (February 2002), produces a cost of equity range between 10.04 and 12.04 percent for a traditional utility. The midpoint of this range is 11.04 percent. The current authorized rates of return for Consumer Advocate's proxy group averaged 11.8 percent. (Tr. 115).

However, the February rate, 7.54 percent, represents the lowest yield in the 12-month period from March 2001 through February 2002. Consumer Advocate suggested that a 12-month average be used to determine the A-rate bond yield. A post-hearing exhibit filed by Consumer Advocate shows that the 12-month average is 7.73 percent, which produces a cost of equity range from 10.23 to 12.23 percent. Because the Board is setting a rate that will be applicable as long as GDMEC continues to be a Board-regulated utility asset, it is more appropriate to use a 12-month average for the A-rated bond yield. As shown by Consumer Advocate's exhibit, the monthly yield can fluctuate dramatically.

The risks associated with a generation investment justify a return that is at the top of the risk premium range. Capital costs are relatively low, at least in comparison to historical standards, and a fixed return for the life of the plant provides certainty to MidAmerican and relatively low risk to ratepayers. In addition, such a return is justified by the intent of section 476.53, which is to encourage new generation in Iowa. Because of the other ratemaking principles granted, however, a competitive return in the 13 percent range is not justified. Taking into account the risks associated with new generation, the intent of section 476.53, and the current state of the capital markets, the Board will adopt a fixed return at the high end of its risk premium analysis using a 12-month bond yield average, 12.23 percent.

5. Conclusion

The Board emphasizes that the regulatory principles set in this proceeding may be unique. There will be no mechanical application of principles approved in this proceeding. Each generation plant is different in size, use, type of fuel, etc. The principles that apply to one plant may not be appropriate for the next. The record developed will be different. However, the Board will continue to compare the risks the utility is willing to undertake with the principles it is requesting, and attempt to strike a fair balance between risk and reward. The more risk, the more reward; the less risk, the less reward.

FINDINGS OF FACT

1. It is reasonable to find that MidAmerican has in effect a Board-approved energy efficiency plan as required under Iowa Code § 476.6(19).

2. It is reasonable to find that MidAmerican considered other long-term sources of electric supply and GDMEC is reasonable when compared to other feasible alternative sources of supply.

3. The four uncontested ratemaking principles are reasonable. These principles deal with capital structure and cost of debt and preferred securities, jurisdictional allocation, other plant components, and settlement impact.

4. It is reasonable to find the depreciable life of GDMEC for ratemaking purposes is 27.6 years.

5. It is reasonable to exclude GDMEC capacity and investment from any calculation of excess capacity or an excess capacity penalty, provided that a

corresponding load adjustment based upon a 20 percent normal weather reserve margin is made from the excess capacity calculation.

6. It is reasonable to modify MidAmerican's proposed ratemaking principles to set a "soft" cap for GDMEC expenditures, exclusive of AFUDC, at $357,487,996.

7. It is reasonable to set the return on common equity for GDMEC at the upper end of the Board's risk premium analysis, 12.23 percent, as long as GDMEC continues to be a Board-regulated utility asset.

CONCLUSIONS OF LAW

The Board has jurisdiction of the parties and the subject matter in this proceeding, pursuant to Iowa Code chapter 476 (2001 Supp.).

ORDERING CLAUSES

IT IS THEREFORE ORDERED:

1. The application for determination of ratemaking principles filed by MidAmerican Energy Company on November 13, 2001, is granted to the extent discussed in this order and denied in all other respects.

2. Motions and objections not previously granted or sustained are denied or overruled. Any argument in the briefs not specifically addressed in this order is rejected either as not supported by the evidence or as not being of sufficient persuasiveness to warrant comments.

3. MidAmerican Energy Company, pursuant to Iowa Code § 476.53(3)"f," shall notify the Board within 20 days from the date of this order whether it intends to proceed with construction of GDMEC consistent with the regulatory principles contained in this order.

UTILITIES BOARD

/s/ Diane Munns

/s/ Mark O. Lambert

/s/ Elliott Smith

ATTEST:

/s/ Sharon Mayer
Executive Secretary, Assistant to

Dated at Des Moines, Iowa, this 29th day of May, 2002.